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AN EXAMINATION OF APPROACHES TO  
POLICY-BASED NONPROJECT ASSISTANCE

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by

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PREFACE

This overview of policy-based, nonproject assistance is based on literature concerned with structural adjustment lending of the Agency for International Development, the International Monetary Fund, and the World Bank. It is intended as a contribution to the continuing discussion within A.I.D. on the role of policy-based, nonproject assistance in stimulating economic development.

For more detail on A.I.D. programs and references, as well as those of the World Bank and the International Monetary Fund, see Working Paper #???, "Approaches to Policy-Based Nonproject Assistance, from which this paper is drawn. Full references for material used are also provided there. It is available ....

### The Need for Policy Reform

The recipe for development is about one part economics and two parts politics. Any freshman student of economics, for example, can explain the results for a nation when it consumes and invests more than it produces without adequate provision for capital inflow and its productive use--inflation, pressure on the exchange rate, balance of payments difficulties, and growing internal and international debt, in one combination or another. Measures designed to alleviate this familiar syndrome may seem to number about one per economist, whereas the single overarching non-economic solution rests on a factor often called "political will."

Large parts of the world today, especially Sub-Saharan Africa, are in economic and political disarray, with incomes and per capita agricultural production falling, and with high degrees of political instability. In Latin America large external debt is shaping policy decisions that have high short-run economic and political costs. The rate of increase in world trade is slackening off, and newly emerging economies are finding it more difficult to penetrate world markets.

In this world context, two great ideologies compete for center stage. One stresses the individual's freedom of action, market forces and competition, price as an allocator of resources, and the constrained role of governments. The other espouses government organization of the economy, limits to freedoms that might interfere with the state's decision-making authority, and a belief in the inefficiencies of markets. Each ideology comprises intellectual and political ingredients, and each claims to represent society's best hope of achieving material plenty while enhancing humane values.

In the 1950s many newly emerging nations adopted a political and economic development strategy based on a strong government, planning, large state sectors, and single party leadership. Whatever the full range of causes, this approach did not provide either development or the full flowering of the human spirit. Many nations became economic and political disasters. Even states which adopted what appeared to be a market-based approach were often so freighted down with the burden of single party (read, single man) leadership that cronyism and authority dominated and markets never were given the chance to operate. Still, as long as some growth occurred, such high cost models could be continued, even if largely to the benefit of the directors of such systems.

Several major events in the 1970s precipitated the current emphasis on policy reform, the attempt to strike an optimal

balance between the positive but constrained role of government and the necessarily more open-ended role of private initiative. The rapid increase in oil prices caused immediate problems throughout the world economy, but it most severely affected less-developed countries. The second oil shock in 1979 again worsened the economic position of these countries, but this time adjustment problems were compounded by rising interest rates on loans less-developed countries sought to maintain consumption in the face of falling real incomes. Third, population pressure in many areas began to threaten development and political stability, and rising productivity displaced short-run redistributive schemes as the single most important way of raising the poor out of poverty. Finally, political thinking in the developed countries began to reflect a broad suspicion that the boundaries of state authority had been extended too far into their market economies, resulting in declining productivity, reduced or negative growth rates, and worsening income distribution, and this thinking began to be felt in the advice given by more developed countries to less-developed countries.

Many less-developed countries now suffer from multiple and profound problems: macro-economic imbalances, inflation, and unsustainable rates of domestic resource absorption; reductions in net capital inflows and in some cases increases in net capital outflows; and heavy debt burdens that require raising domestic savings to very high levels. These countries need to expand and diversify exports, while addressing the high cost of required stabilization and structural changes.

This situation has resulted in a growing emphasis on policy reform, mainly in sub-Saharan countries and in middle-income countries with severe debt service problems. In donor programs, policy reform efforts take a variety of forms, ranging from education through persuasion to conditions that are attached to loans and credits. All attempts at reform contain common elements: smaller budget deficits, tighter monetary control, more realistic exchange rates, and similar macroeconomic measures. Also, conditions attached to loans often encourage institutional change such as the freeing of markets and a reduction in the role of parastatals. Finally, some conditions relate to strengthening a government's technical ability in such areas as budgeting and civil service management.

In brief, the argument in favor of policy reform rests both on the need to reverse the collapse now being experienced in many less-developed countries and on the Western economic tradition of Adam Smith's market-led development. The other Western intellectual tradition of statist development is clearly on the defensive, both in the West and in various Soviet-type economies worldwide.

The Theory of Reform and the Need for a  
Strengthened Analytical Framework

Essentially "the market" is a system in which decentralized units operate autonomously on the basis of knowledge generated within the market system. The concept traces back not only to Adam Smith but also to the important debate among academics in the 1920s and 1930s between the advocates of planning and those favoring markets, one of the most important debates ever to occur among economists on the relationship between knowledge and rational economic decision-making. It was part of the open ideological debate stimulated by the Russian Revolution over the relative merits of socialism and capitalism. Its central issue was the most efficient procedure for the generation, diffusion, and use of decentralized knowledge.

The market model is just one possible arrangement for providing rules for decision making, information generation and processing, and institutional and individual motivation, key features of any economic system. The basic case for the market is that economic decisions will most closely reflect individual wants and resource scarcities when they are decentralized among autonomous, privately-held producing units. These units are efficient because they have the best information available on consumer needs and production capabilities, and serve the individual (motivational) needs of the producer (who keeps the profit) as well as the worker (who keeps his wage). When markets are competitive, and there are no significant external effects (the case of public goods, for example, or externalities in production), price forms the main kind of information needed by both households and producers for rational decision-making which associates ends with the means of satisfying those ends. The role of government in this model is one of referee, providing "honest weights and measures," and providing legitimate public goods.

Clearly, the case for the market can be stated strongly, and underpins conditionality in A.I.D., the World Bank, and the IMF. However, serious conceptual problems remain in the application of market criteria, as will be noted below.

Robert Cassen in 1986 coordinated a major intergovernmental study of aid effectiveness, and his conclusions reflect the importance of policy-based aid flows as well as their limitations. His major findings are as follows.

- Experience with policy dialogue ranges from the reasonably successful to the conspicuously unsuccessful. In effect, it is easier to identify common faulty policies (overvalued currencies, unsatisfactory price structures, and the like) than to design a strategy that is appropriate to each country's

capacities and likely to succeed in contemporary conditions.

- Sometimes inadequate consideration is given to the relationship between short-run programs and the requirements for future development. For example, exchange rate reductions will need longer term support in poorer countries than in middle-income countries. Similarly, higher prices to farmers must be supported by provision of essential inputs such as credit, fertilizer, appropriate plant varieties, and transport. Particular attention must be paid to effects on the poor as food prices increase.
- The success of policy reform rests heavily on the institutional capacity of the less-developed countries. This includes the political commitment of the leadership and adequate negotiating strength and analytical capacity, which may require technical assistance. In the absence of these criteria, the policy reforms will be viewed locally as having been imposed.

In evaluating the effects of A.I.D. conditionality and structural adjustment programs, Ron Hood, Judith McGuire, and Martha Starr concluded in 1988 that "significant variation [exists] between countries in the degree, duration and distribution of hardship associated with the transition." With respect to the degree and duration of hardship, three important factors are:

- The magnitude of the adjust problem. In general, the larger the magnitude of the adjustment problem, the larger the initial contraction required to stabilize the economy. Countries with heavy debt burdens and significant terms of trade deterioration have been particularly likely to undergo pronounced--and sometimes prolonged recession (e.g., Chile). This includes many of the heavily indebted middle-income countries, as well as low-income countries in Sub-Saharan Africa.
- The "deep-rootedness" of the adjustment problem. In general, the longer the period of postponing adjustment via ad hoc measures, the more deep-rooted the problem becomes in the sense of producing a distortion-driven economic structure. Large divergences between the pattern of investment, production and employment and underlying international competitiveness tend to produce large initial contractions in inefficient sectors and long periods before growth resumes. In contrast, some countries developed large cyclically

induced macro imbalances in the early 1980s that had to be addressed through stabilization; but because their underlying economic structures were basically competitive, growth resumed, unemployment fell, real incomes returned to normal levels, etc., with world economic recovery (e.g., Costa Rica).

- The level of development and degree of economic dynamism. The speed at which benefits of adjustment materialize depends on countries' level of development and degree of economic dynamism. For example, the medium-term impact of devaluation on encouraging efficient import substitution and non-traditional export promotion is likely to be much greater in a context where a dynamic groups of industrial entrepreneurs already exists. Higher food prices raise small farmers incomes and induce a supply response only if they are integrated in to the market via a system of decent roads. Reorienting government services to target the poor may take an unacceptably long time if the bureaucracy does not work well to begin with. In other words, while adjustment may be a necessary condition for sustained growth and development, it is not necessarily sufficient.

These cautions aside, the theory of markets remains a powerful tool of analysis, and the market remains a strong driving force in policy formulation throughout the world. There is an important qualification, however. The conditions that underlie market efficiency are very stringent, and unlikely to be found in practice. These "efficiency conditions" are said to be met when the economy is in such perfect "balance" that no one can be made better off without making someone else worse off.<sup>1</sup> They include, for example, "perfect competition," and the necessity that prices reflect full social costs and that producers and

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<sup>1</sup>When economists mention "efficient," they usually have in mind the line of thought developed by Vilfredo Pareto, a 19th century Italian economist and sociologist. One condition is that the marginal rate of substitution (in consumption) between any two goods, or between any goods and leisure, should be the same for all consumers, in the absence of externalities. This provides for efficient allocation of goods. A second condition is that the marginal rate of substitution (in production) between any two inputs should be the same for all producers, whether producing the same or different goods. This provides for efficient allocation of resources. Income distribution is taken as given, and there is the further assumption that the welfare of each individual depends solely on his own consumption and is not affected by the consumption of others. In this model, prices must reflect full social costs (no externalities).

consumers alike adjust their consumption and input decisions precisely in accord with such prices.

Because these conditions tax credulity, economists have explored the significance of policy recommendations in their absence (i.e., in the real world of market imperfections of various kinds). In this "second best" real world it is recognized that if even one of the efficiency conditions is not met, then all consumption and production decisions become economically ambiguous. This means that if there are, for example, important elements of monopoly in the economy, then the welfare effects of this or that policy recommendation can never be fully understood.

K. Toh of A.I.D. explored this possibility in a paper presented to A.I.D. economists in 1984. His central point summarizes well the significance of second-best solutions. Because in practice it is very difficult to trace the complicated effects of one change on the rest of the economy, he suggests that three implications follow.

First, it is unwise to advocate any particular policy without understanding the particular circumstances under which the policy operates. Second, the argument for government controls in order to correct the failings of unregulated markets is generally not valid. Government is not omnipotent. It is not only markets which fail; there are government failures too .... Third, given the facts that market failures are relative and not absolute, and the continuing presence of the second-best problem, one practical solution is to compare the relative efficiency between public and private sectors and allow each to do those things which it can do better than the other.

In sum, the central lessons taught by the second-best problem and the more general limitations of our analytical base are that global policy suggestions are inappropriate, and that within a national economy smaller, but certainly more cautious, steps may be better than larger ones until the full implications of a policy change become apparent.

Another reason for caution has been expressed in a critique of Bank programs by one of its officials. The market-based, analytical model guiding conditionality does not provide a quantitative guide to the behavioral relationships linking inputs (policy actions) and outputs (macroeconomic performance). In the absence of such a framework linking, for example, trade reform to changed levels and patterns of trade, the long-term outlook is far clearer than the short-term outlook. In effect, the specific effects of the reform are somewhat unpredictable, especially in the short-run. This is another argument for going cautiously,

and with great attention to costs, in establishing conditionality.

### Conditionality within A.I.D.

A.I.D.'s approach to conditionality essentially is based on variants of the two-gap model, with some consideration given to the monetary approach to the balance of payments, and is similar to the World Bank's approach.<sup>2</sup> Essentially, it is based on a commitment to reforming all government policies that reduce efficiency, employment, equity, or growth, while recognizing the extent of the trade-offs among these variables. To achieve these goals, the conditions attached to loans are derived basically from neoclassical economics and growth theory and embody a pragmatic approach to institutional changes that support market-led development.

The pattern of A.I.D. conditionality is revealed in several recent studies. A.I.D. conditionality provisions by policy area and country in fiscal year 1986 are shown in Table 1. The one fact that stands out is the extraordinary sweep of these conditions--they cut across the entire economy. A.I.D. conditionality is similar in scope to programs of the World Bank and the IMF, as shown in Table 2, which summarizes areas of policy reform in Somalia by donor.

A GAO study in 1985 examined A.I.D. conditionality in six countries (Costa Rica, Honduras, Egypt, Bangladesh, the Philippines, and Sudan). Only 6 of the 19 Development Assistance (DA) projects required government action as conditions precedent

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<sup>2</sup>The World Bank analytical model is based on standard neoclassical economics and variants of the two-gap growth model, which stress the saving-investment balance and foreign exchange constraints. The model emphasizes the availability of external resources (which can close either gap) and the capital requirements necessary to sustain planned growth targets. The focus is on national accounts and real variables in a Harrod-Domar model of an open economy which suggests the dynamic relationship between the capital stock and output

The IMF approach to conditionality is derived from the monetary approach to the balance of payments. This approach uses a flow-of-funds methodology and is concerned solely with nominal magnitudes. The IMF's emphasis is on measures to reduce balance of payments deficits in the short run, whereas the Bank's conditionality is directed more toward raising growth rates to raise living standards and avoid balance of payments deficits in the medium and long run.

Table 1. A.I.D. FY 1986 Conditionality Provisions by Policy Area and Country

FISCAL	Promote Exports	PRIVATE SECTOR
Tax Reform Jamaica Senegal	Belize  Require Purchase or Attribution of Equivalent amount in U.S. Commodities (code 000) Bolivia Costa Rica Dominican Republic Ecuador Guatemala Israel Jamaica Mozambique Panama Somalia Tunisia	Deregulate Price and/or Controls Belize Ecuador Grenada Kenya Mozambique Togo
Improve Tax Administration Haiti Honduras Jamaica Senegal		Decrease Administrative Controls/Regulations Kenya
Reduce Expenditures Chad Costa Rica Dominican Republic El Salvador		Enhance Access to Markets and Productive Resources Dominican Republic El Salvador Mozambique Somalia
MONETARY	Require Purchase or Attribution in Code 000, 899, or 941 Countries Only	
Limit Domestic Borrowing Costa Rica El Salvador Honduras	El Salvador Egypt Grenada Honduras Sudan	Enhance Entrance Into Selected Activities Somalia Togo
Limit External Borrowing El Salvador		Reduce Price or Market Controls Belize Kenya Togo
Permit Interest Rates To Rise to Market-Clearing Levels Ecuador	Enhance Private Sector Access to Foreign Exchange Costa Rica Honduras Mozambique Somalia	Increase Access to Domestic Credit Somalia
Enhance Private Sector Access to Commercial Credit Costa Rica Togo	Reduce Restrictions on Exports Belize	Increase Private Sector Access to State Agricultural Holdings Dominican Republic
EXTERNAL TRADE	Reduce Administration of Restrictions on Exports	PARASTATALS
Limit/Reduce Export Taxes Dominican Republic Zaire	Belize Kenya Haiti Senegal	Divest Parastatals Costa Rica Grenada Panama
Reduce Import Tariffs Ecuador Kenya Senegal Zaire	Foreign Exchange (general) Zaire Zambia	Restrict Parastatal Activities Belize Grenada
	Reduce/Eliminate Difference Between Official and Market Exchange Rates Costa Rica	

Source: A.I.D. (1986).

Table 3. Areas of Policy Reform in Somalia, by Donor

Donor	Exchange Rate Unification	Exchange Rate Freedom	Civil Service Reform	Privatization of Parastatal	Recurrent Costs	Interest Rates	Liber- alized Market- ing	Liber- alized Input Supply	Bank Privatization	Surrender Requirement	End Price Control	Food Aid
A.I.D.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Low as possible	Yes	Yes
World Bank	Yes	Yes	Yes	Only when appropriate	Yes	Yes, but might ac- cept subsi- dies for some sec- tors	Yes	Yes	Yes	Ok as tax at these rates	Floors, ceilings	No
IMF	Yes	Not neces- sary	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Necessary	Floors, ceilings	No
Germany	Yes, support IMF	Not neces- sary, but encouraged	Yes	Yes	No	Yes, weakly	Yes	Yes	Yes	--	Floors, ceilings	No, UNHCR only
Italy	Yes, weakly	Yes, weakly	Yes, weakly	Ambiguous	Italy will pay them	Yes, weakly	Yes	Yes, weakly	No hope <sup>a</sup>	--	Slow, gradual	No
France	Favor, but don't expect it	Yes	Yes strong- ly, but no action	Yes, lead to investment	Not much	Yes	Yes	Yes	Yes, but not French bankers	Eliminate if possible; useful as tax	Yes	No
U.N. Agencies	Not inter- viewed	Not inter- viewed	Yes, but only push- ing	Where appropriate	Yes, but not pushing	Not inter- viewed	Yes	Yes	Not inter- viewed	Not inter- viewed	Floors, ceilings	Yes (WFP)

Note: The donor opinions reproduced in this table are drawn largely from interviews with representatives in Somalia. Exceptions are the World Bank, whose Somalia Agriculture Projects Officer in Washington, D.C., received the team and provided them with his policy options documents, and the IMF and A.I.D., which also provided the team with policy option papers. While the IMF, the World Bank, and A.I.D. have active stances on all of the policies mentioned in the table, the other donors usually do not. The French, German, and United Nations agencies do not attach any conditionality provisions to their aid and thus engage only indirectly in policy dialogue. They say they are in the country to help the Government of Somalia or for humanitarian and or political reasons. The Italians are the most important bilateral donor in Somalia, but their program is coordinated very little if at all with those of the other donors. Most of the Italian assistance is outside of the Public Sector Investment Program and was conceived in reaction to the pressures of the Government of Somalia requests and Italian commercial interests.

Source: Goldensohn, Harrison, and Smith (1987).

or covenants. Of the eight Economic Support Fund (ESF) programs studied, the four with policy conditions were in Egypt. In general, where A.I.D. did not use project conditionality there were at the same time significant ESF programs with conditionality.

The GAO report noted the difference in emphasis and scope among the three types of assistance (DA, ESF, PL-480), and concluded that each is unique in serving as a vehicle for the policy dialogue which is expected to result in policy change. There is, however, the additional consideration of the political and strategic position of the recipient country in A.I.D. programming. Given the gradations of political and strategic position among countries receiving A.I.D. assistance, it is difficult to generalize in the abstract on the success of policy dialogue. It worked well in some places and poorly in others.

A different perspective is provided by a study of A.I.D. conditionality in its 1986 Commodity Import and Cash Transfer programs. Conditionality was employed with greatest frequency in the Latin America and Caribbean regions, and used scarcely at all Asia and the Near East. Sub-Saharan Africa fell in between those extremes. Second, where conditionality was employed, it tended to become more comprehensive and detailed as the amount of resources devoted to the program increased. Third, while A.I.D.'s use of conditionality is increasing, the total amount of its resources conditioned on macroeconomic performance still constitutes a comparatively small proportion of total U.S. bilateral economic assistance. In FY 1986, for example, 20 percent of ESF resources had some conditionality of this kind attached.

The study found that economic policy conditions attached to Economic Support Fund programs fall into four categories: (1) nonfinancial public sector (reducing expenditures; promoting tax reform; dismantling price and market controls, including low prices paid by parastatals for agricultural commodities; rationalizing the public investment budget; reducing subsidies; and divesting or restricting the activities of parastatal enterprises); (2) monetary policy (reducing the public sector's capacity to borrow domestically or abroad, decontrolling of interest rates, and channeling more credit to the private sector); (3) foreign trade and exchange rate policy (reducing tariffs or administrative controls on imports, and, less commonly, eliminating export taxes, loosening administrative requirements for exports, and reducing the gap between official and market rates of foreign exchange); (4) policies toward the private sector (eliminating price controls and enhancing access to productive resources and markets).

There were additional conditions such as tying of the

stabilization/structural adjustment program to the purchase of an amount of goods equivalent in value from the U.S. or a restricted group of LDCs. This condition was applied to all countries in the Latin American region except Haiti whose trade already was heavily oriented toward the U.S.

The study also revealed that conditionality varied by region. The countries in Asia and the Near East, including the leading recipients of U.S. economic assistance, are subject to negligible conditionality. Conditionality in the Sub-Saharan region is relatively more concentrated in the external and private sectors. In the Latin American and Caribbean region, there is a wider variety of conditionality with greater frequency than in the other regions, and conditionality was more evenly distributed among the four functional areas noted above.

Conditionality rarely applies to only one functional area in either Africa or Latin America. Similarly, it was also rare for a recipient to be simultaneously subject to conditionality in all four areas. The only exceptions were Costa Rica and El Salvador, both of which had comparatively large programs.

A.I.D.'s experience with policy conditionality in Mali, Somalia, Zaire, and Zambia, was studied in 1987, and the results can be summarized as follows (quoting and paraphrasing from the final report):

Agricultural sector impacts. (1) Farmers responded to changes in incentives. There is clear evidence that farmers responded to freer markets and price signals and made choices that maximized their welfare. (2) Policy reforms led to significant increases in food production. In the presence of adequate rainfall, donor-assisted policy reform programs were the dominant causes of increased food output in Somalia, Zambia, Zaire and Zimbabwe. (3) The major beneficiaries were small farmers. (4) Agricultural policy reforms had a quick impact on output and income. This supports the view that the quickest way to lift African agriculture from its current stagnation is to support reforms in the producer's incentive structure. (5) Policy reforms had the greatest impact where other constraints were less binding. (6) Policy reforms promoted private sector development in rural areas.

Economy-wide impacts. (1) Distributional equity has improved and the urban bias of the economic systems has been reduced, results consistent with the United States' fundamental goals in supporting policy reforms. (2) Market structure and spending reforms helped African governments in their efforts to cut budget deficits. (3) Reform programs had favorable effects on balance of payments. (4) Macroeconomic progress has been slow because of bad weather, falling export prices, and large debt service payments.

Implementation. (1) Policy reform implementation failures can defeat the best program (Zambia was most seriously affected by these problems). (2) Price interventions were extremely difficult to manage. (3) There was insufficient donor assistance to keep import levels from falling and inflation from increasing.

Role of donors. (1) In some cases, the combination of financial necessity and common sense led to structural adjustment even without reform programs. (2) At the same time, external assistance was critical to the adoption of policy reforms by African governments. (3) A.I.D.'s role has been both catalytic and supportive.

Continued emphasis on policy reform. (1) Policy reforms are not the only answer to Africa's economic problems, but they are an important part of the answer. (2) Policy issues stretch beyond the purview of African governments (e.g., African debt and future world trade are international issues). (3) It is important that the United States and other donors maintain their commitments to reform programs if these programs are to succeed.

A study of the impact of Zaire's economic "liberalization program" casts some light on how women fare under policy reform (Sines et al. 1987, pp. E-6 and E-7). Its conclusions are as follows:

- In Zaire, women provide a major source of labor in food crop production. The accrual of the gains made under policy reform by women depends to a large extent on intrahousehold decision making. To the extent that this process is inequitable to women in individual households, women will not share equitably in any production or income increases.
- Women account for only a small proportion of those involved in plantation agriculture. Policy reforms which favor this sector will not have as large a positive impact on women as those favoring the traditional sector.
- Women are important in all aspects of the food marketing chain. Women farmers appear to be selling more as a result of price liberalization. The impact on their nutritional status was unclear, however.
- Price liberalization has had a positive impact on the number of women traders. Abolition of prohibitions on interregional trade has had a positive impact on women as they are free to benefit from price differentials between regions.

- Policies which require a husband's permission before women can obtain bank accounts and sometimes credit have a negative impact on married women's access to banking services. These policies have had a negative impact on the operations of women traders.

While the Zaire experience may not be a guide to expectations everywhere, the differential impact on women of various kinds of policies does suggest strongly that this impact must be an important consideration in program design.

### Operating Characteristics of Programs

Policy-based nonproject assistance among major donors can be viewed in terms of its various operating characteristics. There are, for example, various effectiveness issues attached to different kinds of aid such as its accountability, its efficacy at the national versus the sector level, and the best kind of linkage between nonproject assistance and other aid. There are issues related to the consistency of application of assumptions and remedies in applying nonproject assistance among countries of different sizes and institutional capacities.

Measuring the effects of policy change resulting from carrying out conditionality provisions is extraordinarily difficult. There is no single quantitative measures, such as rate of return, for example, by which a program can be judged. The essential problem is the absence of the counterfactual--that is, knowledge of the conditions that would have prevailed in the absence of the program, or the effects that would have been experienced under alternative programs.

Essentially there are four difficulties common to evaluating the effects of program conditionality: (1) the precise links between policy dialogue and policy change are not clear; (2) the precise links between policy change and expected change in the economy are uncertain; (3) it is difficult to separate the effects of a specific policy change from those effects resulting from policy changes stipulated in other programs, from changes in external factors such as export markets, and from major internal events such as drought or especially good weather; (4) when a policy change is merely the first of an anticipated series of such changes, the findings of the evaluation will depend heavily on when it is carried out.

Because of these limitations, emphasis in the evaluation of nonproject assistance is sometimes confined to nonquantitative indicators such as performance disbursement benchmarks that indicate the extent to which conditionality provisions were

actually carried out. This amounts to checking on the degree to which stipulated changes have been carried out, with funding divided into a series of tranches which are disbursed on the basis of satisfactory progress in implementing policy and institutional reforms. The benchmark approach is a practical method of checking what has occurred under a program, but it is unsatisfactory to those seeking a synthesized measure of economic effects of the program.

In sum, evaluation of the effects of nonproject assistance remains an undeveloped art. This suggests that evaluation of nonproject assistance will continue to rest heavily on various performance indicators measuring the extent of compliance of a government with the conditions stipulated.

#### Advantages and Disadvantages of Conditionality

The major advantages and disadvantages of conditionality are presented in Boxes 1 and 2. They are drawn from criticism from the entire spectrum of literature on structural adjustment. (Accordingly, some of the language in the boxes quotes from or paraphrases this literature.) No judgment is made on the validity of these arguments; rather, they are intended to convey the range of controversy surrounding conditionality.

There is no easy way to balance the advantages and disadvantages of policy-based program lending. A case can be and has been made in favor of each argument. In one sense, a balanced judgment will rest on two factors. First, much more analytical and empirical work is required on all aspects of the effects of conditionality. Second, the way one approaches the questions that need to be asked of conditionality, and indeed the questions themselves, will be affected by the researcher's world view, i.e., whether the researcher "believes" that less-developed countries can prosper in the world economy in a positive sum game, or whether those countries inevitably will lose in their struggle with more developed country in a zero sum game.

Is there any consensus on conditionality? In general, there is widespread belief among major donors that policy-based assistance is not only appropriate but necessary given the crisis proportions of the development problem today. Among major recipients, there is a record of such assistance being associated with economic growth and alleviation of poverty. A few recipients have repudiated the agreement backing policy-based lending (e.g., Zambia). There has been no serious suggestions, however, that policy reform in those countries be repudiated as a principle. Instead, there are suggestions that in some cases policy reform should be carried out more slowly and cautiously, and that conditionality should be accompanied by greater economic

BOX 1. ARGUMENTS IN FAVOR OF POLICY-BASED ASSISTANCE

1. The policy setting in many developing countries inhibits growth and the achievement of equity. In many cases, the policy environment has become a hodgepodge of regulations, price fixings, prohibitions, and bloated and dysfunctional state sectors, resulting in the stagnation of economic growth while population continues to increase. The support that had once existed for statism began to erode in the grim light of reality--poverty, ignorance, and corruption. A solution was needed, and because the policies favoring state-led growth have come to be viewed as parts of the problem rather than as solutions, greater reliance on market forces is necessary. No matter what the imperfections of the market might be, both market and government failures must be addressed.

2. Political stability is the key to economic growth and economic growth is the key to political stability. While the evidence on the relationship between good policies and good growth can be debated in some cases, there is no case for the idea that a nation can have good growth without good policies. Similarly, while the evidence on the relationship between growth and political stability can be debated in some cases, there is no case for the idea that political stability can exist in the presence of economic chaos and decline. A semblance of stability might appear, but only at the cost of great repression of commonly accepted liberties. Finally, economic growth in which the bulk of the gain goes to a minority is not growth for the majority, so it does matter that the growth be shared somewhat equitably, which, in turn, further enhances political stability.

3. While random external events will affect development, economic growth and welfare depend primarily on domestic policies. External events can have an uplifting as well as a depressive effect on a nation's economy. Further, some economies are heavily export and/or import dependent and appear therefore to be "vulnerable" to world markets or to their chosen trading partners, as in the case of trade with Eastern Europe. How such a country adjusts to this apparent disadvantage in the long run depends on the policy set chosen in the short run. Even the poorest country in the world can choose a policy set appropriate to its economic condition. To the extent that local leadership is less interested in growth than in its own perquisites, then this generalization does not hold, and policy reform seems of rather academic interest. The result under this circumstance is economic stagnation and growing immiserization.

4. Conditionality may help developing country leadership accomplish its own goals. In some cases, policy changes that create economic losses for particular groups threaten the political strength of leaders and would not be made unless nonproject assistance were conditioned on the change. It is folklore in development circles that A.I.D. or other donors give advice to countries (either indirectly through dialogue or directly through conditionality) that their own leadership would like to give. While competent explanations of the dysfunctional policy and institutional settings often are available locally, there are indeed cases where outside advice has been helpful. Of course, in some cases, if the conditions are made public, the incumbent government may be threatened. This is obviously a delicate procedure. Nevertheless, outside advice can sometimes strengthen the political hand of local leaders who propose policy reform, provided the donor engages in true dialogue that is supportive rather than imperious.

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## BOX 2. ARGUMENTS AGAINST POLICY-BASED ASSISTANCE

1. Limited knowledge base. The gap between policy and its expected results is enormous even in developed economies. In developing countries undergoing rapid structural change, and for which the database is seriously limited, it is fantasy to suppose that any policy planner can "manage" economic development by changing interest or exchange rates, stipulating budgetary limitations, and the like. In effect, the operational mechanism through which policy changes affect reality is something of a "black box." Moreover, prices in such developing countries sometimes are unreliable indicators for rational investment decisions among projects, sectors, and regions. At best, policy recommendations should be limited to such critical issues as developing technical competence among developing country economists and others dealing with the economic problem, establishing local and international institutions for the ongoing review of problems and policies, providing for coordination among donors who express interest in providing assistance, and so forth. Thus, the limitations of our knowledge suggest a wider attempt at building local technical capacity and institutions capable of addressing policy issues on a continuing basis. Finally, the emphasis on market-oriented conditionality may represent wishful thinking, for in the very countries held up as examples of such growth, governments have exerted a strong influence on the shape of the economy (e.g., South Korea, where the Government has directly and indirectly influenced capital allocation for three decades).

2. Inherent ideological bias of policy-based lending. For various reasons, some economically emerging countries have chosen a development strategy emphasizing equity and growth as co-equal goals. This has sometimes led to dysfunctional expansion of the state sector, corruption and the elevation of "politics over economics," and economic collapse. In urging standard policy reform measures, however, donors are in effect substituting their own version of "the good life" (growth before equity) for that of the developing country (growth and equity). If the elimination of absolute poverty is a major objective, then the strategy of development must be designed to achieve this, based on conditions indigenous to the country. If a tendency toward egalitarianism is important, then policy conditionality must reflect this reality.

3. "Getting the prices right" is only the beginning. Although donors are concerned with short-run costs of adjustment programs, the compression of consumption following application of conditionality still receives insufficient attention. Equity may depend in part on current policies (direct aid to the poor, for example), but it also depends on who owns the economic assets and who controls the system. When there are wide disparities in asset ownership, the market widens rather than lessens income differentials. In effect, the ascendancy of policy reform lending is a return to a trickle-down strategy of development that ignores the lessons of history that led to the movement away from such theories and toward a "basic human needs" approach. Similarly, even with market-determined prices, there remain problems of structural rigidity, provision of public goods, widespread training problems, and institutional constraints. These problems are as important as prices; in fact, a case can be made that without attention to these problems, a market system will be difficult to create or maintain.

4. Asymmetrical policy conditionality. While stringent policy conditionality is applied to many developing countries, major lending countries engage in some of the very practices they condemn in developing countries. The difficulty of coordinating policy among Western Europe, Japan, and the United States dwarfs the policy problems of most developing countries. Further, the disarray in the agricultural policies of most developed countries surely matches the agricultural policy miscalculations in developing countries, although with different results. Growing trade restrictions in developed countries against exports of developing countries gives the game away as one of continuing attempts at exploitation of developing countries. (The limitations imposed by the United States in its Caribbean Basin Initiative are viewed among developing countries as symbolic of the real difficulty faced when a developed country proposes "helping" a developing country.) The basic difficulty with this asymmetry is that it reinforces within developing countries a climate of suspicion that assistance to them is a game among developed countries played out largely for internal political reasons, with the interests of the developing countries taking a distant second place to developed countries' concerns with their own economies. In the long run this approach has two effects: (1) it makes cooperation more difficult around mutual interests that surely exist between developed and developing countries, and (2) it fuels acceptance of radical thought from Eastern Europe, the Soviet Union, and China that suggests that the only safe course for developing countries is alignment with world socialism (Soviet- or Chinese-type).

assistance to ease the transitional costs, especially among the poor.

All of this suggests that while policy-based lending is controversial, more frequently than not it has been associated with economic success. It may be expected, therefore, that policy-based assistance will remain a permanent part of major donors' portfolios for the indefinite future.

### Beneficiary Impact

While critics may concede that on balance better policies mean faster economic growth, they often insist that the poor do not benefit, or may actually suffer, from such growth. Who are the gainers and losers?

The programs which have been subjected to the most intense criticism in this regard are those of the IMF. However, these programs have been the most actively and visibly defended. The IMF's defense of its programs is recounted below because it is representative of the thinking among major donors, including A.I.D..

The IMF's basic argument is that while there may indeed be some reduction of consumption as a result of its structural adjustment programs, this may affect all groups rather than just the poor. In any case, it is stressed that this compression would have been greater in the absence of its adjustment programs and the financial support they provide. Specifically, the IMF view is that the distributional impact of exchange rate devaluation is mixed in the short run, in the long run improved growth and employment will occur so that all groups will share in higher national income.

In the monetary area, appropriate policies on money creation and credit tend to curb inflationary pressures, which should help the poor who usually do not own assets that would rise in value with inflation. This beneficial effect is somewhat counter-balanced by the fact that established and urban firms are in a better position to compete for credit than are smaller firms in the rural sector, so the distributional benefit from appropriate credit policies is not as great as might first appear. At the same time, however, interest rate decontrol provides smaller firms in the rural sector greater access to credit.

The distributional impact of fiscal policy is also mixed. On the revenue side, through improved direct taxation the distribution of wealth and income can be made less unequal, and this is possible as well for selected indirect taxes. On the expenditure side, getting civil service size and salaries under

control will have an immediate positive effect on distribution. Reduced subsidies, which result in increases in prices of food, transportation, and petroleum, ultimately will increase employment. Current food subsidies for the poor largely ignore the very poor who live in rural areas. Under any circumstance, food subsidies must be targeted much more closely to the lowest-income households.

The only economically and politically adequate defense of policy-based, nonproject assistance which will hold up in the long run is that in fact the poor do benefit. To ensure this, it is necessary to view policy reform and poverty reduction as complementary goals, not opposites. This means, in turn, that poverty must become a policy focus in any program for change intended to enhance overall economic growth. The important point is that economic crises will force adjustment in some form. Policy-based program lending provides the opportunity for an orderly transition away from the problems. However, without adequate attention to the poor the transition itself is threatened, as is the likelihood of permanent improvement.

In brief, if the claims of poverty alleviation are seen as opposed to the needs for structural adjustment, in a crisis situation the claims of poverty might be ignored. For this reason, actions taken to alleviate poverty must become a supportive part of the policy reform package, contributing to increased productivity and growth and not seen merely as income transfers which will reduce growth.

Work done at the Overseas Development Institute in London notes the following kinds of actions which have been taken under recent Bank lending, cited with permission of the Bank. (A.I.D. was also active in some of the countries cited.). These actions were intended to: (1) enhance the access of the poor to productive assets through land reform that is associated with adjustment, as was done in Thailand; (2) increase the rates of return on assets held by the poor, as done in Ivory Coast, where positive income distributional effects resulted from higher agricultural prices; (3) improve access to gainful employment through assistance to retrenched public-sector employees (as in Gambia and Guinea-Bissau), and in emergency employment schemes (as in Chile); (4) maintain or increase the rate of human capital accumulation of the poor through protection of social expenditures, particularly health and education, as done in Brazil and Indonesia; (5) target income and consumption transfers to the poor whose incomes are not increased by structural adjustment, as discussed in the case of food subsidies in Morocco and Jamaica.

The central point is that positive programs enhancing the contribution that the poor can make to structural adjustment can

be built directly into policy-based programs, and will be acceptable as parts of the growth process. The few remaining instances where transfers are required for the poor will be seen as a relatively small part of such programs.

Even assuming that programs are designed to help the poor, the evaluation difficulties noted above remain important in judging beneficiary impact. The time frame for a program "payoff" may be a decade, and over that period different groups may benefit in different ways. To the extent that price distortions are reduced, for example, the beneficial impact in the short to medium term is almost certain to be in the rural sector. And since women play such an important role in that sector, women stand to benefit.

#### Summing Up

With all the qualifications and cautions attaching to conditionality, among most observers there is consensus that while structural adjustment programs cannot ensure economic growth, policies that inflate economies and distort resource allocation are inherently suspect as hostile to economic growth. Giovanni Cornia and Frances Stewart in 1987 summarized "a few general lessons worth distilling" from the structural adjustment experiences of 10 countries.<sup>2</sup> These are as follows.

- The shocks to which the majority of the countries had to adjust were exogenous (i.e., the results of changes in the international environment or in climatic conditions, both factors beyond the control of national authorities).
- Adjustment is necessary. Whatever the nature of the shock affecting the economy, countries have to adjust to a changing environment. Failure to do so normally entails huge losses of output and human welfare.
- Growth-oriented approaches with structural adjustment have been successfully adopted. While several of the 10 countries analyzed followed predominantly contractionary policies, others adopted more growth-oriented approaches incorporating elements of structural adjustment, and in some cases of human protection.

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<sup>2</sup>Botswana, Ghana, and Zimbabwe in Africa; the Philippines, South Korea, and Sri Lanka in Asia; and Brazil (Sao Paulo), Peru, Chile, and Jamaica in Latin America.

- Growth-oriented adjustment is necessary but not sufficient to protect vulnerable groups.
- In the short-to-medium term, the well-being of children and other vulnerable groups can be protected and even improved with the adoption of appropriate targeted programs, even during periods of economic decline.
- Most programs aimed at protecting the poor are relatively inexpensive in terms of total government expenditure and GDP.
- Foreign financing is important in facilitating a smooth program of adjustment. While the availability of medium-to-long-term financing in sufficient amount allows the investment necessary for structural adjustment, external assistance (often to meet foreign exchange costs of imported inputs) for specific programs designed to protect the poor also proved an important element for the successful protection of human conditions.

These conclusions point to serious problems but also provide a basis for optimism. Some strategies for economic growth and alleviation of poverty do exist. However, what kind of growth occurs--whether it improves the lot of the poor or not--largely depends on the kind of strategy chosen.

The general lessons of structural adjustment and policy reform outlined above can be given broad programmatic definition. First, some asset redistribution is necessary, either with economic growth or prior to growth, including tenurial changes, massive education, and broad investment in assets that are complementary to those assets owned by the poor, such as nutrition and education, irrigation, and credit programs or input subsidies. A second complementary strategy is to increase the relative and absolute demand for unskilled labor, which should be accompanied by the strengthening of institutions that improve labor mobility and access to jobs. Both strategies imply yet a third strategy to move prices (including exchange rates) closer to clearing levels.

A study of World Bank experience by Lionel Demery and Tony Addison in 1987 gives added weight to the suggestion that structural adjustment can be carried out while providing protection to the poor. They examined attempts of more than a dozen less-developed countries to assist the poor while undertaking structural adjustment. Basically, they found that the effort must be made to increase the participation of the poor in activities that are expanding under structural adjustment and to maximize the ability of the poor to generate income, so that

transfer payments may be targeted solely to the most vulnerable groups. They "distinguish five broad approaches to assisting the poor under adjustment: (1) increasing their access to productive assets; (2) raising their return on assets; (3) improving their employment opportunities; (4) ensuring their access to education and health services; and (5) supplementing their resources with transfers." In short, these approaches provide many examples of the possibility of protecting the poor while undertaking structural adjustment.

Because there is nothing magical about these strategies cited above, considerable controversy surrounds each suggestion. Perhaps the best that any government can do in the matter of economic policy reform is to try to achieve and retain an optimal balance between regulation and other forms of government intervention and the free play of market forces. Both theory and experience (as seen, for example, in the Japanese and Korean models) suggest that a vital and growing economy requires both a strong private sector and a strong and proactive government.

There is yet another perspective on specific interventions that support policy-based adjustment. In a sense, the essential development problem facing less-developed countries is not that the potential of the market is not understood. Rather, it is that changes that took centuries to achieve in developed countries are being collapsed into decades in less-developed countries. In many cases, there has not been enough time for the institutional, cultural, and political development that underlies market-led growth to occur. Some common features of societies integrated through markets are a system of laws protecting property and contracts, stable and predictable governments, acceptance of the rule of law surrounding civil liberties, broad-based capital markets and a reliable system of public accountancy, the concept of relatively equal opportunity, and spirit of rationality. From this perspective, a strategy of development must combine broad-based policy adjustment with those projects that help less-developed countries overcome the institutional and cultural deficiencies that impede market development but that require more time to correct.

On the whole, A.I.D.'s experience with policy conditionality has been positive, as reflected in several country evaluations, although many difficulties remain. Current evaluation efforts in A.I.D. will be devoted to estimating the impact of policy reform on lower income groups in less-developed countries. Preliminary results for Africa will be available by mid-1989.

There is little doubt that the effort at policy reform is overdue and appropriate. Wildly out of balance budgets, overvalued exchange rates, inefficient government restrictions on the sale of agricultural products, and a host of similar economic aberrations usually produced the opposite of growth--economic



Because policy reform changes the balance of power among groups in the economy, it is both an economic and political act. From this perspective, perhaps the main problem encountered in encouraging policy reform is to convince the leadership that they will be able to survive, and even prosper, while at the same time giving up power and authority. This is why policy reform cannot be imposed from the outside if it is expected to be of lasting value. Policy dialogue requires patient, long-term (decade or more) collaborative efforts among donors and recipients alike if it is not to become just another promising, but failed, development fad.

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